



Economic Observatory

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China's fuel price hike: a good timing and a right policy move

The National Development and Reform Commission (NDRC) announced on late Monday to increase retail prices for gasoline and diesel by about 600 yuan (\$87.80, about 10% hike) per tonne, and jet fuel prices were also raised by 1000 yuan (up 22%) .

It is the third time that China raised fuel prices since March in an attempt to bring the price in line with international level (Table 1). After this time rise, retail fuel price reached to highest level ever in recent history.

At the beginning of this year, China reformed its oil product pricing mechanism in order to align domestic fuel price with international oil prices. Under the new system, domestic fuel prices can be adjusted when the moving average of a basket of international crudes changes more than 4% over a period of 22 working days. The crude basket includes North Sea ICE-Brent, Middle East Dubai and Indonesia's Cinta.

Market Reaction

This move surprised the market. However, if the government were to follow the new price-setting mechanism, the market can predict the price adjustment and give investors and fuel users plenty of time to hoard fuel before the likely price rise. In this sense, it puts the government in a dilemma on whether to follow the mechanism and hand a windfall to speculators or abandon the new pricing system. The government had delayed a predicted rise in early May according to price setting mechanism to June 1 to avoid over speculation. Meanwhile, it appears that the government has the ability to flexibly utilize the new mechanism and gave the rumors little time to gather steam.

The impact of fuel price hike on CPI

The 10 percent rise for gasoline and diesel will alleviate the falling trends for the price indexes, which has been negative for consecutive months (Chart 1), and it will provide positive support to CPI and PPI.

This is consistent with our view about China's price outlook.

Li-Gang Liu

lliu@bbva.com.hk

Yuande Zhu

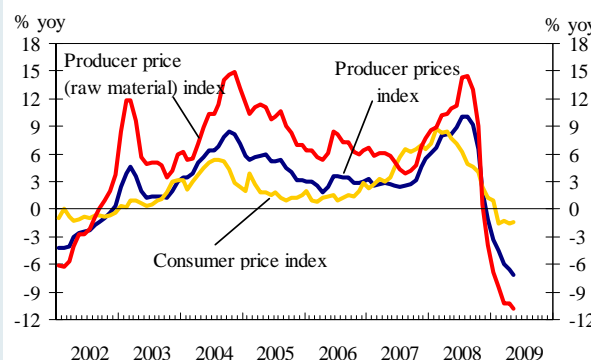
yzhu@bbva.com.hk

Table 1: History of China's Fuel Price Adjustments
(RMB / tonne)

Date	Gasoline	Diesel	Jet Fuel
2005-03-23	4,050	3,320	4,140
2005-05-10	4,050	3,470	4,140
2005-05-24	3,900		
2005-06-25	4,100	3,620	4,440
2005-07-23	4,400	3,870	4,740
2006-03-26	4,700	4,070	5,040
2006-05-24	5,200	4,570	5,540
2007-01-14	4,980		5,450
2007-11-01	5,480	5,070	5,950
2008-06-20	6,480	6,070	7,450
2008-12-19	5,580	4,970	5,050
2009-01-15	5,440	4,810	
2009-03-25	5,730	4,990	3,990
2009-04-01			3,560
2009-05-19			
2009-06-01	6,130	5,390	4,020
2009-06-30	6,730	5,990	5,050

Source: Wind and BBVA

Chart 1: China Price indexes



Source: Wind and BBVA

Although CPI inflation temporarily turned to negative, we expect the price will stabilize and increase again given fast credit growth and rising commodity prices. Besides, China's PPI inflation is highly correlated to price changes in international commodity prices. As the commodity price is trending up, sharp declines in PPI will moderate and eventually pick up again in the coming months. Therefore, a protracted deflation is not a risk. Our baseline forecast for CPI inflation in 2009 is at 0.5%.

The magnitude of direct effect from fuel price hike to mitigate falling pace in CPI is small due to the very low weight for fuels in CPI basket at around 1.2%, so the 10% price rise will translate only 0.12 percentage points in July's CPI index. But considering the spillover effect from fuel price rise, the total effect on CPI will be much higher than 0.12 percentage points. In April and May, the CPI is -1.5% and -1.4% respectively; with the fuel price hike, the CPI might strengthen to reverse its falling trend and the deflation would be moderated, and return to positive territory in Q3.

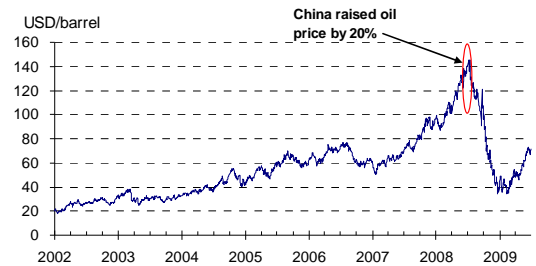
The impact of fuel price hike on consumption

On June 20 2008, China increased domestic fuel price by about 20 percent (Table 1), which triggered a fear that higher fuel costs could slow demand growth in the world's third-largest economy. The move probably set the stage for the crude price to pull off from its record highs (Chart 2).

Will the fuel price hike dampen domestic demand that just began to grow? We believe it will have some effect on certain sectors that are sensitive to changes to fuel prices such as the auto sector, airlines, and transportation sector in general. The price hike will probably dampen China's auto sales, which have surged at a high pace from the beginning of 2009 (Chart 3).

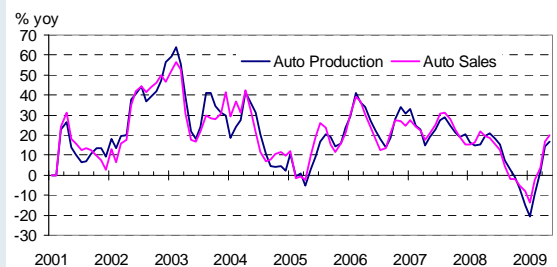
Overall, the fuel price increase is aimed at keeping domestic prices in line with international one so as to reduce government subsidy. More importantly, the more market based price mechanism will also improve the efficient use of resources. We view this is an important move for China to increasingly use market prices to adjust its factor markets.

Chart 2: WTI Crude Price



Source: Wind and BBVA

Chart 3: China Quarterly Auto Production and Sales



Source: CEIC and BBVA